

**STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE
45 Fremont Street, 24th Floor
San Francisco, California 94105**

INITIAL STATEMENT OF REASONS

**RH-01013336
December 30, 2004**

**REGULATIONS GOVERNING NOTICES REGARDING SALE OR
LIQUIDATION OF ASSETS AND STANDARDS FOR MEDI-CAL ELIGIBILITY**

**REGULATIONS REGARDING APPLICATIONS FOR INDIVIDUAL VARIABLE
ANNUITY CONTRACTS, VARIABLE LIFE INSURANCE CONTRACTS, AND
MODIFIED GUARANTEED CONTRACTS**

REGULATIONS REGARDING SENIORS' INSURANCE

INTRODUCTION AND DESCRIPTION OF THE PUBLIC PROBLEM

California Insurance Commissioner John Garamendi ("Commissioner") proposes the adoption of three new articles in the California Code of Regulations:

- California Code of Regulations, Title 10, Chapter 5, Subchapter 3, Article 10.2, sections 2523.20 through 2523.25, entitled "Notices Regarding Sale or Liquidation of Assets and Standards for Medi-Cal Eligibility"
- California Code of Regulations, Title 10, Chapter 5, Subchapter 3, Article 10.3, sections 2523.30 through 2523.31, entitled "Applications for Individual Variable Annuity Contracts, Variable Life Insurance Contracts, and Modified Guaranteed Contracts" and
- California Code of Regulations, Title 10, Chapter 5, Subchapter 3, Article 10.4, sections 2523.40 through 2523.41, entitled "Seniors' Insurance."

Proposed Article 10.2

The purpose of the regulations proposed in Article 10.2 is to implement, interpret, and make specific the provisions of California Insurance Code section 789.8 which pertain to written notices that must be provided to elders or elders' agents in connection with the purchase of a life insurance or annuity product.

The Legislature added section 789.8 to the California Insurance Code when it passed Assembly Bill 2107 in 2000. (In 2001 the Legislature made nonsubstantive changes to section 789.8 to

maintain the code.) AB 2107 was sponsored by the California Advocates for Nursing Home Reform (CANHR) to prevent financial abuse and misrepresentations directed against elderly people. The legislative history of AB 2107 states that elderly Californians are losing millions of dollars because some attorneys and life insurance agents persuade them to purchase financial products which are unnecessary and financially detrimental. For example, some life insurance agents have convinced elderly individuals to liquidate assets in order to buy annuities by telling them that the annuity purchases will enable them to qualify for Medi-Cal benefits. After purchasing the annuities the elderly individuals are often in a worse financial position than before, because they may owe capital gains taxes on the sale of stock, they may owe penalties on withdrawals from an IRA account, they have a set, limited income stream from the annuity, and if they are in a nursing home Medi-Cal eligibility requirements classify principal and income from the annuity as income in calculating the applicant's share of cost. In contrast, the seller of the annuity has profited by receiving a large commission from each annuity sale.

Insurance Code section 789.8 is one component of the Legislature's efforts to prevent these kinds of abuses. Insurance Code section 789.8(a) defines the term "elder." Section 789.8(b) requires life agents to provide written advice to elders that informs them of the possible consequences of selling assets to purchase a life insurance or annuity product and that suggests that they may want to obtain independent legal or financial advice before purchasing a life or annuity product. Section 789.8(c) provides that a life agent who offers for sale or sells a financial product to an elder based on the product's treatment under the Medi-Cal program may not negligently misrepresent the treatment of any asset under Medi-Cal as it pertains to the elder's eligibility for any public assistance program. Section 789.8(d) sets forth the notice that every life agent must provide to an elder or the elder's agent if the life agent offers to sell or sells any financial product on the basis of its treatment under Medi-Cal.

The proposed regulations implement, interpret, and make specific the provisions of section 789.8. For example, to avoid confusion and ambiguity, section 2523.21 of the proposed regulations defines terms used in section 789.8 and in the proposed regulations themselves. To prevent life agents from implementing the requirements of section 789.8(b) in such a way as to make them ineffective, such as printing the required writing in very small type or drafting it in a misleading way, the proposed regulations set forth a standard form and format for the writing, which is called a notice. To prevent life agents from circumventing the requirements of sections 789.8(c) and (d) by disputing whether a sale or offer to sell a financial product was made on the basis of the product's treatment under Medi-Cal, section 2523.23 of the proposed regulations defines when a transaction is made on the basis of a product's treatment under Medi-Cal and thereby interprets and makes its provisions specific. To ensure that the statutorily-required notices are provided before the sale of a financial product rather than afterwards, and that agents and insurers keep adequate records of the notices, section 2523.24 of the proposed regulations states when notices must be presented and signed, and it specifies applicable record-keeping requirements. Section 2523.25 clarifies which penalty provisions apply to violations of the regulations.

The proposed regulations are reasonably necessary to carry out the intent of the Legislature when it amended section 789.8 of the Insurance Code. The Commissioner proposes the adoption of

these regulations pursuant to the authority vested in him by sections 789.6(h), 12921(a), and 12926 of the California Insurance Code.

Proposed Article 10.3

The purpose of the regulations proposed in Article 10.3 is to implement, interpret, and make specific the provisions of California Insurance Code sections 790.03(a), 790.03(b), and 10127.10.

California Insurance Code section 10127.10 provides that applicants for certain life insurance and annuity products who are 60 years of age or older may choose to have their premium invested in a fixed account, money-market fund, stock fund, or bond fund for the duration of the 30-day “free look” period required by the statute. The proposed regulations require that application forms for products that offer the choice of investments during the 30-day “free-look” period must contain language that enables the applicant to make the investment choice before a contract is issued and thus before the 30-day time period begins. Presenting the applicant with the investment choices before the 30-day period begins rather than after it has started is the simplest, most effective and most inexpensive way to effectuate the investment choice provisions of section 10127.10.

The proposed regulations are reasonably necessary to carry out the intent of the Legislature when it added section 10127.10 to the Insurance Code, and to avoid misleading consumers about the existence or nature of the investment choices which the law makes available to them. The Commissioner proposes the adoption of these regulations pursuant to the authority vested in him by sections 790.10, 12921(a), and 12926.

Proposed Article 10.4

The purpose of the regulations proposed in Article 10.4 is to implement, interpret, and make specific the provisions of California Insurance Code sections 785 and 787.

California Insurance Code section 785(a) provides that all insurers, brokers, agents, and others engaged in the transaction of insurance owe a prospective insured who is 65 years of age or older a duty of honesty, good faith, and fair dealing. California Insurance Code section 787 provides in part, “Any advertisement or other device designed to produce leads based on a response from a potential insured which is directed towards persons age 65 or older shall prominently disclose that an agent may contact the applicant if that is the fact. In addition, an agent who makes contact with a person as a result of acquiring that person’s name from a lead generating device shall disclose that fact in the initial contact with the person.”

The Commissioner is aware of repeated instances in which unlawful marketing schemes such as “living trust mills” are used to target senior citizens for the sale of annuities. As part of the living trust mill scheme, senior citizens are asked to provide their names, addresses, and other personal information, but generally they are not told that this information is being obtained so that insurance agents can contact them later to sell them annuities.

The proposed regulations are reasonably necessary to carry out the intent of sections 785 and 787 in that they require advertisements to carry a prominent disclosure which tells seniors that when they attend the seminar, their names may be made available to insurance agents for the purpose of selling insurance. The Commissioner proposes the adoption of these regulations pursuant to the authority vested in him by sections 789.6(h), 12921(a), and 12926 of the California Insurance Code.

SPECIFIC PURPOSE AND REASONABLE NECESSITY FOR REGULATIONS:

The specific purpose of each regulation and the rationale for the Commissioner's determination that each regulation is reasonably necessary to carry out the purpose for which it is proposed is set forth below.

ARTICLE 10.2

SECTION 2523.20. Authority and Purpose

Section 2523.20 sets forth the authority for promulgating the proposed regulations and states that the purpose of the proposed regulations is to implement provisions of Insurance Code section 789.8. The rationale for adopting section 2523.20 is to set forth the legal authority for this rulemaking and to identify the provisions of the Insurance Code being implemented.

SECTION 2523.21. Definitions

The purpose of this section is to define certain terms used in Insurance Code section 789.8 and the proposed regulations which would otherwise be unclear. The definitional sections are reasonably necessary to eliminate confusion about the meaning of the terms defined. Section 2523.21(a) establishes that the definition of "elder" used in the proposed regulations is the same as the definition of that term set forth in Insurance Code section 789.8(a). Section 2523.21(b) defines "elder's agent," a term used in both Insurance Code section 789.8 and the proposed regulations, to eliminate disputes about who is an elder's agent and who is not. The term "financial product" is used in Insurance Code section 789.8 but is not defined. Section 2523.21(c) of the proposed regulations defines "financial product" in a manner consistent with Insurance Code section 789.8 and, pursuant to Insurance Code section 785(c), in a manner consistent with the scope of Insurance Code, Division 1, Part 2, Chapter 1, Article 6.3 (of which Insurance Code section 789.8 is a part). Section 2523.21(d) clarifies that the "Notice Regarding the Sale or Liquidation of Assets" set forth in proposed regulation section 2523.22(c) is the written advice required by Insurance Code section 789.8(b).

SECTION 2523.22. Notice Regarding the Sale or Liquidation of Assets

Insurance Code section 789.8(b) provides that if a life agent offers to sell any life insurance or annuity product to an elder, the life agent shall advise the elder or the elder's agent in writing

concerning the financial consequences of selling or liquidating assets to fund purchase of the product. Although the general nature of the advice is set forth in the statute, the statute does not set forth the wording of the advice and does not describe how the written advice is to be formatted. The rationale and purpose behind the proposed regulation is to standardize and make specific the requirement for providing written advice so that individuals selling life or annuity products can not circumvent the statute or render it ineffective by wording or formatting the advice in a confusing or misleading way, or by printing the advice in small, hard-to-read typeface. Once the wording and format of the written advice is standardized, it will be easier to enforce the statute because there will be fewer disputes about whether or not the written advice given by the agent complies with section 789.8(b). This will eliminate an issue in enforcement cases brought against sellers of life insurance or annuity products. In addition, the standardized language makes it easier for agents to comply with section 789.8(b); if they use the standardized notice they can rest assured that they have met the requirements of 789.8(b).

Section 2523.22 sets forth the language and format of the written advice required by Insurance Code section 789.8(b) in the form of a notice. Section 2523.22 requires that the notice be printed in at least 12-point type with portions of the notice in boldface type so that it is easier for elderly individuals to read.

The proposed regulations also require the elder or the elder's agent to sign the notice to indicate that the notice was read and received. The bottom of the notice contains blanks for the elder or the elder's agent to sign the notice and to note the date and time of signature. The date and time requirements can assist a trier of fact in determining the date, time and location at which a sale or attempted sale occurred (or even assist in determining the elder's mental state) and this additional evidence can aid in enforcement efforts against unscrupulous agents. The date, time, and signature requirements also serve as a record for insurance agents that they have complied with the requirements of the statute.

SECTION 2523.23. Notice Regarding Standards for Medi-Cal Eligibility

Insurance Code section 789.8(d) states that a life agent "who offers for sale or sells any financial product on the basis of its treatment under the Medi-Cal program" must provide an elder or elder's agent with a "Notice Regarding Standards for Medi-Cal Eligibility." Section 789.8(d) does not define "sold or offered for sale on the basis of its treatment under the Medi-Cal program." If this phrase is not defined, it will be unclear in some instances what conduct is prohibited.

Section 2523.23 provides that a financial product shall be deemed to have been sold or offered for sale on the basis of the product's treatment under the Medi-Cal program "if the life agent provides any information in any manner in connection with the sale of the financial product to the elder or elder's agent regarding the Medi-Cal program." In other words, the life agent's duty to provide the Notice to the elder or the elder's agent arises if the life agent provides any information regarding Medi-Cal that the elder or elder's agent will connect with or regard as part of their decision to purchase the financial product. This information is not limited in scope to written statements. It can be written, verbal, non-verbal, electronic, or information conveyed in

any other manner. The purpose of the statute and the proposed regulation implementing the statute is to require provision of the Notice when any information about Medi-Cal becomes part of the proposed sale or transaction.

SECTION 2523.24. Notice and Record-Keeping Requirements

Section 789.8(b) and (d) do not say *when* the life agent must provide the Notices to the elder or elder's agent. By not stating when a life agent must provide the Notices, the statute could be interpreted to allow an agent to provide the Notices after the elder purchases a financial product – a possibility which defeats the purpose of the Notices and is contrary to the legislative intent of the statute. In addition, under existing law disputes over whether the senior was actually provided with a Notice may rest on the agent's word against the senior's word if the date and time the Notice was provided are not recorded in some fashion and copies of the Notice kept with the agent's or insurer's records. The proposed regulation is reasonably necessary to limit the occurrence of these problems.

The purpose of section 2523.24 is to require the life agent to obtain the elder's or elder's agent's signature and date and time of signature on the Notice immediately before the time the life agent presents the application for a life insurance or annuity product. Section 2523.24 also requires the life agent to provide a copy of the Notice to the elder or elder's agent immediately before the time the life agent presents the application for a life insurance or annuity product. These requirements document that the Notice was provided, when it was provided, and encourage compliance with the Notice provisions of the statute. This protects the interests of both the agent (who has evidence that he or she complied with the statute) and the elder (who has received the Notice(s) before the time he or she would enter into the transaction).

Section 789.8 is silent on record-keeping issues, such as who must keep copies of the notices required by section 789.8 (the agent or the insurer or both?) and how long copies must be kept. Some agents may believe that they do not have to keep records of the notices. The record-keeping requirements cited as reference sections are not new – they already exist in the insurance industry for both insurers (see Insurance Code section 10508) and life agents (see Insurance Code section 10508.5), but existing law does not specifically state that the existing record keeping requirements apply to the notices required by section 789.8. The purpose of proposed section 2523.24 is to clarify the unanswered record-keeping questions created by section 789.8, and to eliminate destruction of the notices, by stating who shall keep the original signed notices, who shall keep copies, and how long the documents shall be kept. The proposed regulation is reasonably necessary to eliminate confusion about record-keeping requirements applicable to the notices, and to require that copies of the notices be kept for a reasonable period of time to evidence compliance with section 789.8.

SECTION 2523.25. Penalties

The purpose of section 2523.25 is to make clear that penalty provisions apply to violations of the regulations implementing section 789.8, and to identify what those penalty provisions are.

Section 789.8 is part of Article 6.3, Chapter 1, Part 2, Division 1 of the Insurance Code. The penalty provisions for violations of Article 6.3 are set forth in Insurance Code sections 789 and 789.3. Section 2523.25 confirms that the penalty provisions applicable to violations of section 789.8 also apply to violations of the regulations promulgated to effectuate section 789.8. It clarifies that other penalty provisions may also apply. The rationale for adopting this regulation is to eliminate confusion and disputes over which penalty provisions apply to violations of the proposed regulations.

ARTICLE 10.3. Applications for Individual Variable Annuity Contracts, Variable Life Insurance Contracts, and Modified Guaranteed Contracts

SECTION 2523.30. Authority and Purpose

Section 2523.30 sets forth the authority for promulgating the proposed regulations and states that the purpose of the proposed regulations is to implement provisions of Insurance Code section 790.03(a), 790.03(b), and 10127.10. The rationale for adopting section 2523.30 is to set forth the legal authority for this rulemaking and to identify the provisions of the Insurance Code being implemented.

SECTION 2523.31 Applications for Individual Variable Annuity Contracts, Variable Life Insurance Contracts, and Modified Guaranteed Contracts that are Required to Set Forth Investment Choices

The purpose of the regulations proposed in Article 10.3 is to implement, interpret, and make specific the provisions of California Insurance Code sections 790.03(a), 790.03(b), and 10127.10.

California Insurance Code section 10127.10 provides that individuals who are 60 years of age or older when they purchase individual variable annuity contracts, variable life insurance contracts, or modified guaranteed contracts will have their premium deposited into a fixed account or money-market fund during the statutory 30-day “free look” period unless they choose to have it invested in a stock or bond fund. Although the statute requires that the consumer be notified of this choice in the contract (Insurance Code section 10127.10(d)), nothing in the statute requires that the consumer be informed of the investment options *at the time they purchase the product*, which is the time the investment decision would be made and the consumer’s money received. Once the product is purchased and the policy is received, the consumer’s money has already been deposited in an investment which may or may not be the type of investment the consumer would choose. The investment might then have to be changed, retroactively, if the consumer chooses a different investment from among the investment choices set forth in section 10127.10.

The proposed regulations provide that application forms for products that offer the choice of investments set forth in section 10127.10 during the 30-day “free-look” period must contain language that enables the applicant to make the investment choice before a contract is issued and thus before the 30-day time period begins. The proposed regulations set forth the language,

which is based in part on the notice required by Insurance Code section 10127.10(d). Some changes have been made to make the language clearer and more understandable to the consumer and to note the greater risk of loss presented by some investment choices. The proposed regulation specifies 12-point bold print and a one-inch space around the edge of the notice, which requirements mirror the formatting requirements of section 10127.10(d). The exception is that the section 10127.10 notice is printed in all upper case letters, which the Commissioner believes is more difficult for consumers to read than regular 12-point print, so the latter is required in proposed section 2523.31. Presenting the applicant with the investment choices before the 30-day period begins rather than when it has already started is the simplest, most effective and most inexpensive way to effectuate the investment choice provisions of section 10127.10.

The proposed regulations are reasonably necessary to carry out the intent of the Legislature when it added section 10127.10 to the Insurance Code, and to avoid misleading consumers about the existence or nature of the investment choices which the law makes available to them.

ARTICLE 10.4. Seniors' Insurance

SECTION 2523.40 Authority and Purpose

Section 2523.40 sets forth the authority for promulgating the proposed regulation and states that the purpose of the proposed regulation is to implement provisions of Insurance Code sections 785 and 787. The rationale for adopting section 2523.40 is to set forth the legal authority for this rulemaking and to identify the provisions of the Insurance Code being implemented.

SECTION 2523.41 Advertising Seminars or Events Directed Towards Persons Age 65 or Older

The purpose of the regulations proposed in Article 10.4 is to implement, interpret, and make specific the provisions of California Insurance Code sections 785 and 787.

California Insurance Code section 785(a) provides that all insurers, brokers, agents, and others engaged in the transaction of insurance owe a prospective insured who is 65 years of age or older a duty of honesty, good faith, and fair dealing. Insurance Code section 787 provides in part that any device directed at individuals age 65 or older that is designed to produce sales leads for insurance agents must disclose that an insurance agent may contact the individual if that is the case. The Commissioner has found that when senior citizens are asked to provide their names and addresses and other personal information at "living trust" seminars and similar events, they generally do not know and are not told that their names are being obtained so that insurance agents can contact them later to sell them annuities. Proposed regulation section 2523.41 effectuates sections 785(a) and 787 by requiring advertisements for events or seminars paid for or disseminated by an insurance company, insurance agent, broker, or affiliate to tell seniors that when they attend the seminar their names may be made available to insurance agents for the purpose of selling insurance. The proposed regulation is reasonably necessary to prevent seniors

from being misled about how their names and other personal information are being used after they attend the seminars or events.

SPECIFIC TECHNOLOGIES OR EQUIPMENT

Adoption of these regulations would not mandate the use of specific technologies or equipment.

IDENTIFICATION OF STUDIES

There are no technical, theoretical, and empirical studies, or similar documents relied upon in proposing the adoption of the regulations. The Commissioner has relied upon the California Legislature's Senate Judiciary Committee report on AB2107 as amended August 7, 2000 in proposing the adoption of the regulations.

REASONABLE ALTERNATIVES TO THE REGULATIONS; IMPACT ON SMALL BUSINESS

The Commissioner has determined that no reasonable alternative exists to carry out the purpose for which the regulations are proposed or which would be as effective or less burdensome to affected private persons than the proposed regulations. Although performance standards were considered as an alternative, they were rejected as ineffective in addressing the problem of protecting elderly consumers from misrepresentations and other violations of good faith in the insurance marketplace.

The Commissioner has identified no reasonable alternatives to the presently proposed regulations that would lessen any impact on small business.

ECONOMIC IMPACT ON BUSINESSES AND THE ABILITY OF CALIFORNIA BUSINESSES TO COMPETE:

The Commissioner has made an initial determination that the proposed regulations may have a significant, statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states. The types of businesses that may be affected are insurance agents and insurance companies. The Commissioner has considered performance standards, but the Commissioner has identified no performance standards that would be as effective as the proposed regulations in enforcing the statutes that form the basis for the proposed regulations. The Commissioner has not considered other proposed alternatives that would lessen any adverse economic impact on business and invites interested parties to submit proposals. Submissions may include the following considerations:

- (i) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to businesses.
- (ii) Consolidation or simplification of compliance or reporting requirements for businesses.
- (iii) The use of performance standards rather than prescriptive standards,

- (iv) Exemption or partial exemption from the regulatory requirements for businesses.

The Commissioner invites interested parties to comment on whether the proposed regulations will have a significant adverse economic impact on business.

PRENOTICE DISCUSSIONS

The Commissioner conducted a prenotice public discussion of the proposed regulations pursuant to Government Code section 11346.45 on August 31, 2004. Notice of the prenotice public discussion was provided to all those who have requested notice of regulatory proceedings conducted by the Commissioner concerning the subject matter of the regulations. The Commissioner received written and oral comments from interested parties at the August 31, 2004 public discussion and on subsequent dates, and the comments have been reviewed and considered in drafting the proposed regulations.